Stocks and bonds

Stock represents a share of ownership in a corporation. A bond is a security that represents a debt owed by the corporation to the bondholder, but does not include the ownership privileges of a stockholder. Stocks and bonds are the staples of many investment portfolios. As an investor, it is important to have a clear understanding of just what these securities can and cannot be expected to offer by way of a return.

The exchanges

When you invest in securities listed on the New York Stock Exchange (NYSE), you are participating in the growth of some of the largest U.S. and foreign corporations. The NYSE lists more than 1,800 stocks and over 2,400 corporate bonds. However, many more stocks and bonds are offered in other established and less well established markets. Among the markets that you may wish to participate in are the American Stock Exchange, the Pacific Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange and NASDAQ.

Common stock

Common stocks – also called common shares, capital shares, or capital stock – represents units of ownership in a public corporation. Purchasers of common stock are granted specific rights that may include the right to:

Vote at stockholders meetings,

Sell or otherwise dispose of their stock,

Have the right of first opportunity to purchase additional shares of common stocks issued by the corporation,

Share pro-rata with other common stockholders in any dividends distributed to common stockholders,

Receive annual reports and inspect the corporation's books and records,

Share in any assets remaining after creditors are paid if the corporation is liquidated.

A corporation may be authorized to issue more than one class of stock. For example, one class of common stock might have enhanced voting rights. Holders of this class would likely pay a higher price for their shares. Usually any additional classes of stock being offered are designated as "preferred stock."

Preferred stock

Preferred stock gets its name from the preferences granted to its owners. These preferences may include the payment of dividends and distribution of assets in case of liquidation. Preferred stock generally does not carry a voting right. This type of stock is issued to raise additional capital without jeopardizing the controlling interests of the common stockholders.

Preferred stock may be participating or nonparticipating, cumulative or noncumulative, callable, convertible, or some combination of these. The benefits of investing in this type of stock are often similar to those of bonds. Most preferred stock dividends offer a fixed rate of income.

Preferred stockholders have an ownership interest in a company's net worth. Such stock is subordinate to the company's debts to bondholders, but it is superior to common stock. Preferred stocks offer relative safety of income, but preferred stock prices usually have a more modest growth potential than common stock.

You should discuss with your broker the various types of preferred stock available and whether they fit into your investment objectives.

How stock is valued

Stock is often referred to as having par value, book value, and market value.

Par Value
Par value is an arbitrary value set by the company at the time of issuance and is of little concern to most investors.

Book value
Book value is calculated by dividing the total net assets of the company by the number of shares outstanding.

Market value
The price at which shares of stock can be bought and sold is called the market value. Shares that are not publicly traded, however, will have no market value.

Vital information about public companies

Information about public companies whose stock is traded on the New York Stock Exchange, American Stock Exchange, NASDAQ, or over-the-counter is contained in the documents these public companies file with the Securities and Exchange Commission (SEC). Among the items reported are:

Financial statements
Description of business
Location and character of principal properties
Legal proceedings
Stock options and compensation of top executives
Proposed offerings of securities
Number of shareholders
Number of employees

Issuers of registered securities must file annual and other periodic reports that provide a public file of current information about the company. These reports include the 10-K, which provides a comprehensive overview of the company. The 10-K is filed within 90 days after the close of the company's fiscal year.

The 10-Q is a quarterly financial report filed by most companies, which although unaudited, provides a continuing view of a company's financial position during the year. The 10-Q must be filed 45 days after the close of the fiscal year quarter. To obtain copies of these reports, contact the SEC.

Dividends and yields

Unlike interest on bonds or certificates of deposit that remains constant, dividends on stock can be reduced or eliminated in lean periods. Profits in good years, however, usually mean higher dividends, increased stock prices, and better returns for the stockholder.

Preferred stock dividends are usually paid at a fixed rate and before dividends are paid on common stock. In addition, most preferred stock dividends are cumulative, which means that if the company fails to pay a dividend when due, the unpaid dividend obligation will accumulate for the benefit of the preferred stock owners. These obligations must be paid in full before common stockholders receive any dividend payments.

Warrants

A warrant is a type of security, usually issued together with a bond or preferred stock. The warrant entitles the holder to buy a proportionate amount of common stock at a specific price that is usually higher than the market price at the time the warrant is issued. A warrant is usually offered as a “sweetener,” to enhance the appeal of the accompanying fixed-income securities.

Bonds

While a share of stock represents partial ownership (equity) in a company, bonds represent debt payable by a company to the bondholders. Interest on bonds must be paid in good times or bad, like any other debts, which may be an attractive feature for investors seeking greater capital security and assured income.

A company issuing a bond agrees to repay the amount borrowed plus a specific rate of interest at an agreed time, the maturity date. On the face of a bond certificate is the name of the company issuing the bond, the serial number, the principal amount of the bond, the rate of interest, and the maturity date.

The quality of a bond usually can be determined by its rating. Ask your broker for the rating of a particular bond you are interested in. If the issuer is creditworthy, bondholders can expect regular interest payments on specific dates. As with any investment, there is a risk that you may lose all or part of your investment should the company issuing the bonds go bankrupt. However, bondholders' claims in a bankruptcy must be satisfied before any payments are made to preferred or common stockholders.

A common area of misunderstanding for those who invest in bonds is the inverse relationship between interest rates and bond prices by which an increase in interest leads to a decline in bond prices. When interest rates are higher than current yields on bonds, demand tends to shift away from the bond market and into the bank market. Bondholders then sell their bonds to take advantage of the more favorable interest rates, creating a downward pressure on bond prices.

Bonds are issued by federal, state, and local governments, and by business corporations. U.S. government bonds are considered the safest, since the U.S. government has the highest credit rating of any borrower. State and local governments offer what are commonly referred to as "municipal bonds," which have the advantage of a federal tax exemption on interest paid.

Corporate Bonds

Corporate bond issues vary widely, but a few of the more common corporate bonds include the following:

Sinking fund bonds
Some bonds are backed by a "sinking fund" for which the issuer is required each year to set aside a certain amount of money to retire the securities when they mature.

Mortgage Bonds
Bonds in which a corporation pledges certain assets (real estate) as collateral to secure the bond payment.

Debentures
These bonds are not secured with collateral or specific property, but are backed by a corporation's general credit. Debentures are not

necessarily less creditworthy than mortgage bonds, and, in fact, some have top credit ratings.

Junk bonds

These are high-yield, high-risk bonds of two types: those which are investment-grade when originally issued, but which have subsequently been downgraded, and those originally issued as low-grade bonds. The latter group includes bonds issued by low-rated companies to finance operations, as well as those issued in connection with corporate takeovers.

Convertible bonds

A convertible bond gives its owner the privilege of exchange for other securities of the issuing company at some future date and under prescribed conditions.

Zero-coupon bonds

Zero-coupon bonds make no periodic interest payments, but instead are sold at a deep discount from face value. The buyer of such bond receives the rate of return by the gradual appreciation of the bond, which redeems at face value on a specified maturity date.

For more information

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